RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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June 28, 1978 **LETTER 733**

June 16, DJIA 836.97; PTI 827; A-D Ratio –18.27
June 23, DJIA 823.02; PTI 816; A-D Ratio –19.29

THE PICTURE: First, a few thoughts: More money has been lost (1) trying to beat inflation, and (2) trying to beat the market, than anyone can imagine. I operate with my own money on the basis of buying what (a) I believe to be great values (b) buying into what I believe to be greatly undervalued markets, and (c) buying "insurance" (which, at the moment, is gold).

I also operate on the principle that we are given what *we need*, not what we want. Thus, I'd love to make a fortune in the market every year (who wouldn't), but I know damn well that I don't need it, and that I'm given what I need in other ways. For instance, I took a position many months ago in gold coins and bullion. On last week's gold breakout above 185 I was sorely tempted to add to my position by purchasing the December futures. But I decided (after a lengthy debate with myself) that such action would border on greed. I concluded that if I bought the December futures I would somehow mess up my whole position and come away with nothing.

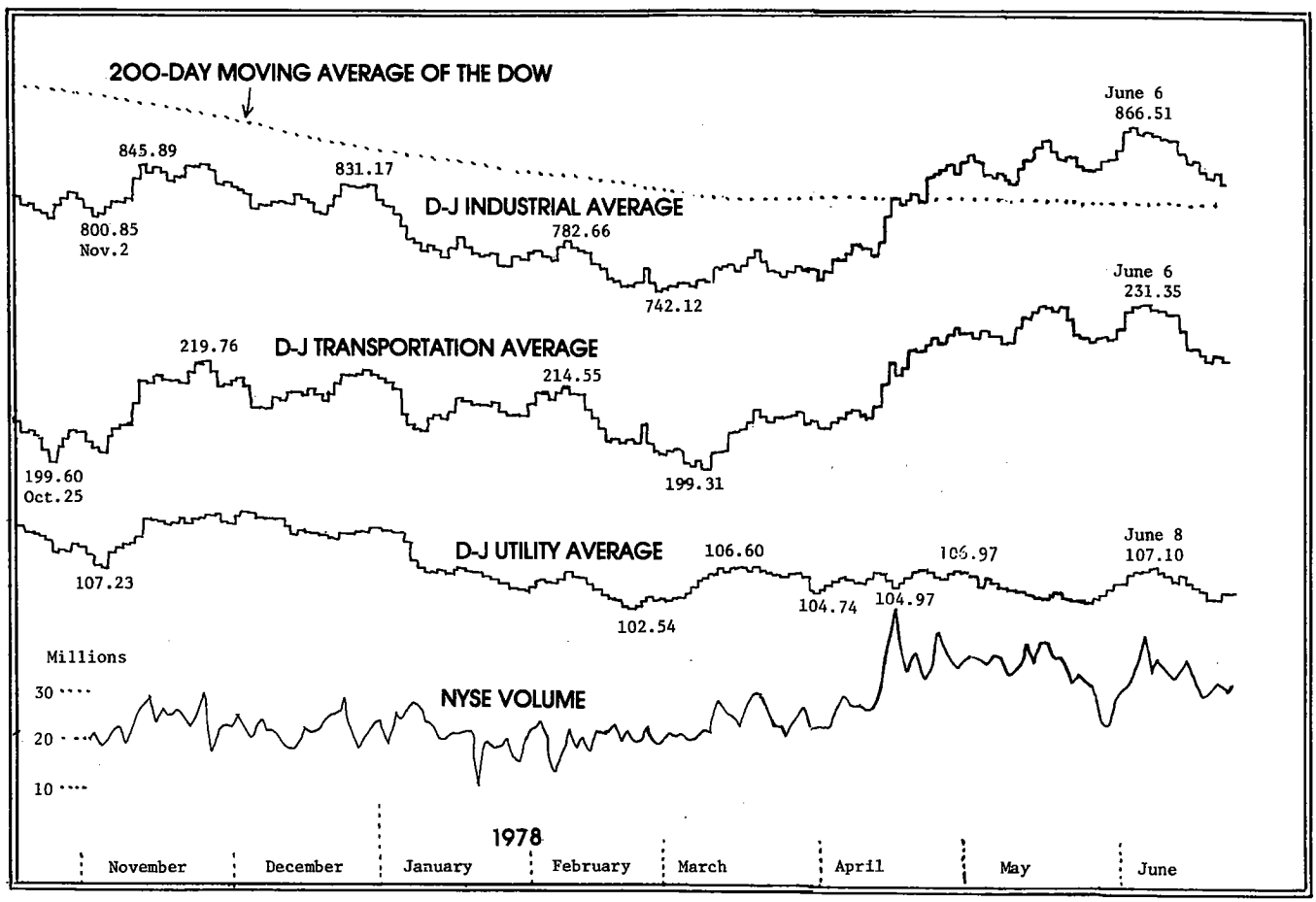
Thus, if gold goes to 200 or 220 or 250 I'll do well enough, and I've learned that well enough is fine with me. Yet I know other individuals who have the faculty of loading up, then loading even further, then margining to the hilt, and in the end making a bundle. In almost every case these individuals needed that bundle or in some strange and exotic way "deserved the windfall." To which I say "more power to them," but such is not my fate.

Furthermore, I have found that when I take too large a position (for me), it fogs up my view of the markets, and since my job is to write about the markets with as clear and unprejudiced a viewpoint as possible, I find it better to invest on the modest side (which helps me with my sleep as well as my viewpoint).

And speaking of viewpoints, I have a few views on what has, and what has not, been happening in the markets. First, I believe the back of the latest bear market rally has been broken. I say this in view of the following:

(1) At the June 6 rally peak (which was 866.51) the Dow halted well short of the critical 50% or halfway level of the preceding primary decline. The 50% level is 878, and it was discussed at length in the last Letter. The fact that the Dow could not (on the greatest volume in history) climb above the 50% level has bearish implications.

(2) On June 6 the Dow turned down in the (inter-day) 870's area. This area is at the level in which my long-term (13-year and 55-month) moving averages of the Dow are turning down—as illustrated in Letter 731 (May 17). This has negative implications.



(3) The big, over-30 million share volume on the NYSE began in mid-April and lasted to late-May. The average price for the Dow during that period was 827. By June 21 the Dow had declined to 824. Thus, the decline bearishly cut below the average Dow price for the whole high-volume period, a period which saw over one billion shares change hands on the NYSE. Negative implications.

(4) As of June 21 the A-D ratio (NYSE) has slid back to its April 19 level. The implication here is that most of the stock purchases executed during the big-volume (mid-April to late-May) period are now showing no profits and in many cases–losses. The implications are again bearish.

Question: Russell, what do you think will be happening over the short term?

Answer: If you look at the page 1 chart of the Averages (or look at the Wall Street Journal chart) you will see that any rally from here on the Dow will build a right shoulder for a potential head-and-shoulders top. The Transports have been acting quite weak. Note that the June 6 Transport peak of 231.35 bettered the previous May peak by only .10. The Utility Average remained flat during the whole advance, and thus it too was weak. I can't tell (and I don't really care) whether the Dow is going to mount a rally from here, but I would guess that any rally will be a weak one and will simply form a right shoulder on the developing top. More importantly, I believe the primary and secondary trends of the market are down.

Question: What do you foresee for the intermediate term, and what kind of strategy are you thinking about?

Answer: I have not recorded a FULLY OVERSOLD bottom for this market since late-1976. I feel that time is militating in favor of such an event, and that the odds heavily favor the appearance of a big, really oversold bottom. Because a major bottom has been so long in coming and because so much buying power has been used up during the 1978 rally, my guess is that the bottom (when it arrives) should be a "whopper." It should produce what I consider to be an area for safe and profitable buying of common stocks. I could be wrong, the market could "mess around" into 1978, but I am guessing that we will get an important bottom this year.

Question: Do you think the bottom will be comparable to the 1974 low?

Answer: No, I don't think it will be that important, but it will nevertheless be a big one. The 1974 low was a major bear market bottom capable of supporting a two or three year advance. I expect that kind of a low to appear in 1979. But for 1978, I still think a profitable bottom will materialize.

Question: Russell, are you saying that we could get two bottoms, an intermediate bottom in 1978 and a massive low point in 1979?

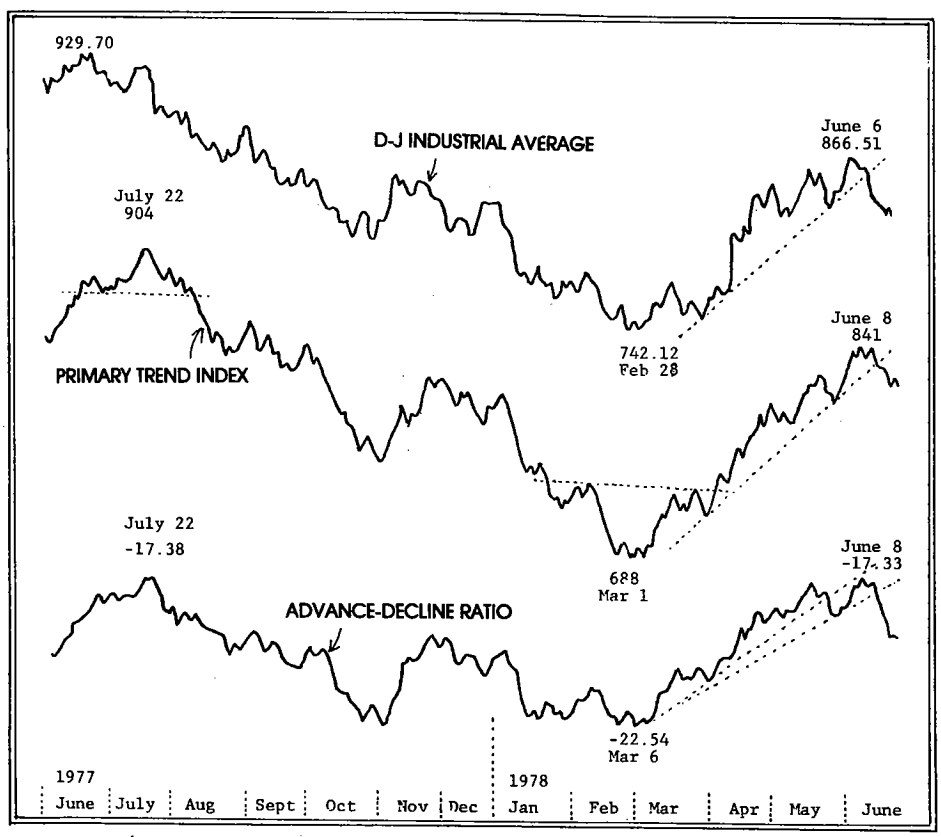
Answer: That's what I think could happen. And that means that we could have very volatile markets coming up with one and very probably two important buying areas. All of which means that I want subscribers to be very liquid right now–very liquid indeed.

Question: If we get the kind of major bottom that you are looking for, will you recommend stocks to buy?

Answer: You bet I will.

Question: What about your 13 and 50 week moving averages? Are they going to signal a major bullish crossing? ?

Answer: The 13 is 1 point under the 50-week MA this week. By construction, they almost have to cross next week (unless the Dow plunges to 760). But I am going to call this a crossing brought on by a bear market rally–and I am going to "pass" on this crossing. As an aside, the 50-week MA is still declining, and that somewhat dilutes the importance of the crossing.



WHERE ARE WE? The accompanying chart traces the daily path of the Dow and two of the indicators which I follow closely. They are the advance-decline ratio (NYSE) and my own primary trend index (PTI).

Let's start with the Dow. The Dow moved up from its February 28 low of 742.12 to a June 6 high of 866.51. This rise represented a recovery of 46% of the 272 points lost during the preceding 17 month decline (the decline from the 1978 high of 1014.70 to the 1978 low of 742.12). It is significant that the Dow in a period of only three months recovered almost half of a decline that consumed 17 months. The rapidity of the Dow recovery has bearish implications. I say this because **bear market rallies tend to be much more rapid** and violent than the primary (bear market) declines that precede them.

Turning to the primary trend index (PTI), this is a proprietary indicator that I developed in 1971 to aid me in determining the direction of the primary trend (or broad sweep) of the market. The PTI is actually an amalgam of 8 different averages and indices, including 4 stock averages, a bond average, the most-active stock index, the A-D ratio and the high-low index. I compute the PTI daily, and I am still trying to improve my skill in reading its messages and implications. The rationale behind the PTI is that one average or index (or even two) may fool us, and this is particularly true if such indices gain too large a following. But a mix of 8 different averages and indices is extremely unlikely to provide false readings.

One interesting facet of the PTI (and this has been fairly consistent) is that it has a habit of forming head-and-shoulders tops and bottoms at key turning points. For instance, note that at the bull market high for the PTI (recorded at 904 on July 22, 1977) a head-and-shoulders pattern was formed. This was followed by the slide in the Dow from 929.70 to the 742.12 low. During the same period the PTI tumbled 216 points to its March 1 low of 688.

Next note that a head-and-shoulders bottom formed in the PTI during January to March. In early April this pattern broke to the upside. The result was the explosive rally to June 6-8. "Ah hah, Russell," you say, "if you saw all this then why didn't you recommend buying?" My answer is as follows: (1) we are in a primary bear market, and I am always very reluctant to buy stocks in a bear market unless we have a condition wherein the market is heavily over-sold. The market did not give me over-sold readings at the late February and early March lows. (2) I have a PROCEDURE for making profits and avoiding losses in the stock market. My procedure is to invest heavily in primary bull markets and generally stay out of primary bear markets. If one follows a policy of attempting to trade bear market swings, the odds are (as many traders found out during 1973-74) that the stock market will cost you your shirt.

Nevertheless, I am more and more impressed by the ability of my own PTI to call important turns and provide critical data regarding the market. I will, in the future, draw readers attentions to all formations in the PTI which hint of the possibility of important reversals.

At the moment, the PTI is indicating a reversal to the downside by violating its rising trendline. Thus, the trend of the PTI from the March 1 low has been broken. Note also that the PTI hit a high on June 8 of 841. This peak was far below the July 22 high of 904. Interestingly, the PTI has performed much worse than the A-D ratio, which I will discuss next.

The A-D ratio is an indicator which traces the direction of the *majority* of stocks on the NYSE. The A-D ratio has now gained a very wide following, with comments on "the breadth" appearing daily in brokerage house releases and even bank reports. For this reason, I would expect the A-D to become a bit more deceptive and less useful than it has been in the past.

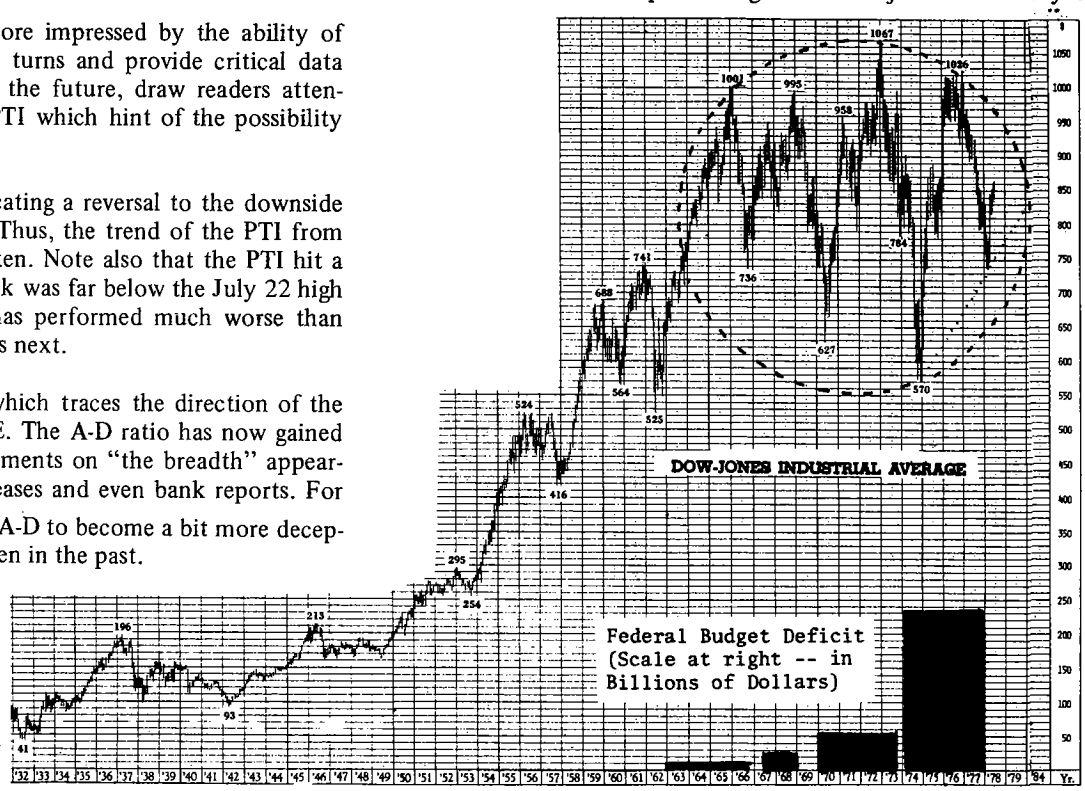
From its July 22 bull market peak to its March 6 low, the A-D ratio lost 5.16 points. Then came the explosive advance. From the March 6 low to the recent June 8 peak the A-D gained 5.21 points. At the June 8 high the A-D actually bettered its July 22 peak by a fractional five-hundredths of a point! Note, however, that the A-D ratio is now violating rising trendlines, and it has therefore turned decisively bearish.

Of particular interest to me is the fact that the A-D has now broken down to the April level (see chart, p. 2). The big, over-30 billion share volume on the NYSE began on April 19. With the A-D down into April territory, all the stocks bought in the frenzied area of the big volume are "locked in." Technically, this is a very bearish situation, and in the past this type of situation has led to drastic losses.

As a point of interest, I have done a good deal of work with the A-D ratio over the years, and I also published the only daily A-D ratio chart album. Some years ago I defined a "buying panic" as a rise of **5 points or more** in the A-D ratio without so much as an intervening 1 point interruption (decline). This type of buying panic occurred when the A-D ratio rose 5.21 points between the March 6, 1978 low and the June 8 high. Following the buying panic, the A-D turned down. On July 19 the A-D gave up more than 1 point. Technically, the buying panic terminated on June 19.

CIRCLE & DEFICITS: The reaction to my "whirling circle" study of the Dow in Letter 731 was most interesting. One subscriber wrote to say that it was "the most ridiculous thing he had ever seen." Many others said that they were fascinated by the study. A New York reader wrote that it was "the most important single chart he had ever seen on the stock market." A California subscriber wrote that "this is really a giant 'diamond pattern' and according to Edwards and Magee such a pattern is a variation of a 'head-and-shoulders top'."

At any rate, I continue to find the emerging pattern (shown here again on the Horsey chart) to be one of great interest. In the last Letter I included some of Ned Davis's statistics on deficits and interest rates, noting that on each of the four expansionary periods since 1963 (1963-66, 1967-68, 1970-73, 1974-78) the Federal deficits have spiraled higher. This is just another way of



saying that it is taking more and more dollars of deficit to do less and less for the economy.

I think the chart is also telling us something else. There can be no real growth where a business or a nation is "loaned up." And loaned up is where this nation, its businesses and its individuals, are now. As a result of the progressively more precarious situation that the US has put itself in (via debt), the stock markets, the commodity markets, and the bond markets have stalled out for the past decade. And as a result of the debt-strangulation that has overtaken the nation, the average citizen has turned to a new method for survival. That method is called GAMBLING. We see it in the stock market (led by gambling stocks), we see it in the new Atlantic City gambling casinos, we see it as corporations and individuals go over their heads in debt in order to keep "the good times rolling."

To get back to the chart, as the deficits (and inflation) have rocketed upwards, the Fed (in each instance) has stepped on the monetary brakes, and in due time the market and the economy have topped out. This inflation-boom-brakes-collapse syndrome is the sequence which has produced what I call the whirling circle pictured on the chart.

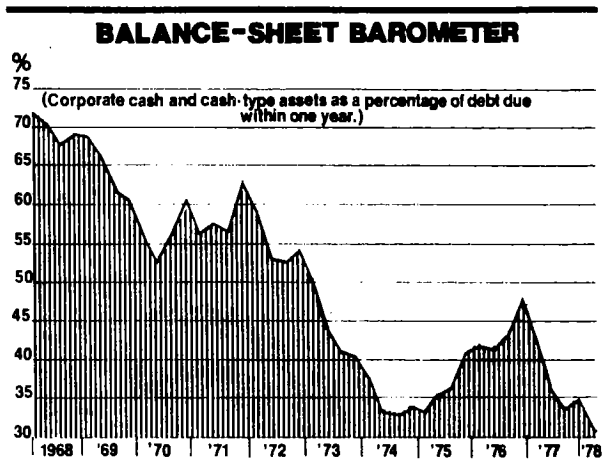
Now we are at it again. The black blocks at the bottom of the chart show the cumulative deficits during the four periods pictured, with the latest block (1974-78) showing the unbelievable $240 billion deficit which has piled up since 1974.

Interestingly, this latest deficit finds the Dow still struggling with the 840-875 level, a level it passed through 14 years ago in 1964! But to my mind, the crucial immediate question pertains to the action of the money markets and the Federal Reserve Board. Fed Chairman Miller has done the "easy part" of his job so far. He has allowed some pressure to hit the money markets, but in the main he has merely followed the money markets with a series of discount rate boosts. From here on, as inflation heats up and as loan demand soars, Miller will have to decide whether he really means business or whether he is just another Arthur Burns, jawing against inflation but allowing the money supply to surge.

In all fairness, Mr. Miller is on the spot. If he follows his current middle course the forces of inflation could run wild. The fact is that business and the American public have become very sophisticated and wise to the ways of inflation, and they have learned to factor rising inflation into their daily lives. Even today's double digit inflation has not put the skids on the economy.

On the other hand, if Miller really clamps down, if he lowers bank reserves, raises stock margins, puts the discount rate up to record levels, he could halt inflation and put out the speculative excitement. But in a nation which literally **exists** on rising deficits, this course could send the US economy off the edge of the cliff.

Why do I say that? A nation that is "loaned up" is not exactly ready to take strong medicine. This chart from the June 14 Wall Street Journal, for instance, shows the tenuous financial position of US corporations. The chart shows that corporate cash as a percentage of debt due in one year has dropped to a Post War low. The picture is one of fantastic complacency on the part of corporations, a feeling that "it may get a bit difficult, but no emergency is looming on the horizon–so why keep a carload of cash around." But the chart shows us that the average



corporation is in no position to withstand a severe squeeze or a debt crisis. The US economy, in a phrase, is ready for good times and fair times but not for bad times.

"All right, Russell," you say, "but what about Jarvis-Gann and the new tax revolt? Isn't this going to hit Washington, and won't that help cut the huge national deficits? After all, what California can do the Federal Government can do."

My answer is that it's going to be fantastically difficult to cut the Federal budget deficits. Even if no new spending goes in, the deficits will remain large based on inflation and programs that are already built into the budget by law. Furthermore, should any economic contraction hit and should tax receipts fall (as they always do during a recession), the federal deficits could reach new record proportions.

Most people don't realize it, but at present an astounding 75% of the entire Federal budget is "uncontrollable" in that it would take changes in existing laws to reduce these programs. This discouraging chart from Merrill Lynch research shows how the uncontrollable part of the Federal Budget has expanded from 59% in 1967 to an estimated 75% in 1979! Therefore, those who believe major cuts in Federal spending are coming are, I believe, doomed to disappointment.

UNIFIED BUDGET: UNCONTROLLABLE OUTLAYS, SELECTED FISCAL YEARS

Fiscal Year	Billions of Dollars Uncontrollable	Controllable	Total*	Uncontrollable as Percent of Total
1967	93.5	66.4	158.3	59.1%
1970	125.8	73.3	196.6	64.0
1973	173.1	76.9	247.1	70.0
1976	267.1	102.8	365.6	73.0
1977	293.6	112.9	401.9	73.0
1978A	339.0	119.5	453.5	74.8
1979A	375.0	129.6	499.4	75.1

*Sum of Uncontrollable plus Controllable less government share of employee retirement contributions.

A = Administration Estimate Source: Office of Management and Budget

I said this in the last Letter and I'll repeat it. I think Jarvis-Gann and all tax-cut and spending-cut bills are basically DEFLATIONARY. They may represent a positive turn of events for the dollar, but remember this: government purchases of goods and services have risen from over $100 billion in 1965 to over $400 billion today! Total government expenditures as a percentage of GNP have risen from 22% in 1950 to 24% in 1960 to 32% in 1970 to an amazing 40% today! Cut that

spending down by even 10% and we'll face a smash. That's the situation we've put ourselves in today!

I think the most discouraging part of the whole picture is the built in government expenditures and the unwillingness or inability of anyone in or out of government to cut the all-consuming US expenses. Of interest at this time are the forecasts of Leonard Santow of *J. Henry Schroder Bank & Trust,* one of the really accurate forecasters of government spending on Wall Street. Santow sees the fiscal deficit careening up $14 billion in 1979 to a peacetime record of around $66 billion. For fiscal 1980 Santow predicts another record budget deficit of over $70 billion.

To my mind, these deficits represent the **overriding ECONOMIC fact** in the US today. In recognition of this, *Fortune* magazine (July 3, 1978) provides this frightening possibility, and I think it is one well worth studying:

A breathtaking slide

> The haunting specter is that, when the economic downturn arrives, the customary countercyclical medicines may be out of reach. Fiscal policy will be oriented to the reduction of the huge budget deficits and in no position to provide new stimulus. Monetary policy may be immobilized by rapid and possibly still accelerating inflation in consumer prices, huge wage settlements, and the threat of a foreign-exchange crisis should interest rates be brought down in such a climate. While this "worst case" can probably be avoided, the peak of the current economic advance is apt to be so surrounded by slippery slopes that the descent, slow or fast, will be a breathtaking experience.

NOTES & QUOTES: I've done pretty well in this business, and I have no complaints, none at all. Wall Street owes me nothing. But I owe Wall Street and a lot of other people a great deal (and these people include the long deceased Robert Rhea, the very much alive Bob Bleiberg, the late James Hughes, the late Hamilton Boulton, Jeff Drew, E. George Schaefer, the list is a long one.

There are a number of gifted gentlemen in this business who have started rather recently. They don't indulge in gaudy advertising, but they deserve a much wider readership than they now have. I want to list three of them, and I imagine that they would be willing to send you samples of their work if you ask for it. At this point I might as well mention that I don't make a nickel on this or anything else mentioned in these reports. I have only one business, and that's publishing Dow Theory Letters. If my mentioning a product helps to sell it, it only means one thing as far as I'm concerned–it's a good product, and I'm all for it and the people who produce it.

I think Bill Bretz's work is tops, and his charts are a revelation. Bill has only been in business about a year and I've found him to be a superb student with a cold, analytic approach to the markets. His service is called Juncture Recognition, Box 1209, Pompano Beach, FL 33061.

Next is R. E. McMaster and his publication, "The Reaper." I encouraged R.E. to start his business, and now I'm encouraging people to get acquainted with the Reaper. Personally, I always learn something from this brilliant fellow's writing. The service is aimed at commodity traders, but McMaster will write about anything from a cycle of wars to the price of gold next week. He's at P.O. Box 39026, Phoenix, AZ 85069.

Ian McAvity (a tremendous worker) turns out (along with Bretz) some of the best graphics in the business and his service is always informative. He is at P.O. Box 182, Adelaide St. Stn., Toronto, Ontario, Canada M5C 2J1.

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I firmly believe the world's troubles would be solved (and the earth would resemble heaven) if everyone would take total RESPONSIBILITY for himself. In talking to hundreds of people, I don't find that 1 in 50 holds himself up, takes responsibility for his own life, does his own thing, accepts his own pain (instead of inflicting it on others). This same refusal to take responsibility spills over into the financial sphere. Today, people insist on their right to everything–as long as you and I pay for it. There's the right to work, the right to go to college, the right to happiness, the right to three meals a day. Who promised everyone all those rights? I believe in freedom of all kinds, except where freedom becomes license and inflicts damage (like the freedom to yell "Fire" in a movie house when there is no fire). But Americans confuse freedom with rights.

A recent fantastic article by Bud Shulberg quotes the author as saying that Sammy (of his famous "What Makes Sammy Run") is now the typical American. Truth and evil aren't the opposites in the great fight today, but success or failure are. Lie, cheat, sneak, steal, but be a success. Beat the hell out of the competition, smash your fellow workers, do what ever you have to do to "express yourself." This is the decade of the narcissist. All's fair in success and winning.

* *

Subscribers have asked me about the June 12 "New Bull Market" piece in *Barron's.* In my opinion, the piece was wrong on all counts. The article states that Robert Rhea "developed and refined" a "3% rule" regarding corrections, and on this reasoning the author has decided that we had a correction in the Averages and then new highs on June 5. The tiny downward blip the author refers to was merely a minor decline, not a correction. Rhea stated that corrections tend to wipe out 1/3 to 2/3 of the preceding primary swings, and nothing we saw from the February 28 low to the June high did any such thing. Nor did Rhea ever formulate a "3% rule" about corrections. I can't figure where the author came up with that one.

I used to answer every public mention of Dow's Theory that I felt was incorrect and which was liable to confuse market students. I've given that up, because it doesn't do any good and because for every correct Dow Theory interpretation–there seems to be about a dozen ignorant ones. Suffice it to say that no bull market signal was given in June, and if by chance this is a bull market, you can't prove it by anything Dow, Hamilton or Rhea ever wrote or said.

* *

I included a rather large section in this Letter on what I think is the biggest issue and also the greatest sickness of our time–the compounding, careening Federal deficits. Last week a local reporter came over to interview me, and he was somewhat amazed by the over-1000 Cactus plants that I am growing in my back yard. He asked "What fascinates you about Cacti?" I replied that it is their extraordinary ability and will to survive, their ability to save today for what they may need tomorrow.

The reporter asked me to explain. "Cacti," I stated, "are the living embodiment of the Bible's warning of the seven fat years

and the seven lean years. You see those Cacti in the ground? (I have some plants in the ground but most are potted). Those plants received about a month of rain last winter, and at the time they fattened up like pumpkins. It hasn't rained since, and it probably won't until this fall or winter (and that tells you something about San Diego's weather!). But those Cacti are ready for the hard times, just as much as Howard Ruff or Harry Schultz are. They save it when the saving is good, and they use it when the hard times come. That's what I find so fascinating about Cacti–aside, of course, from their beautiful flowers." The reporter was much impressed, and he said that he'd like to come back another time and do an article about Cacti.

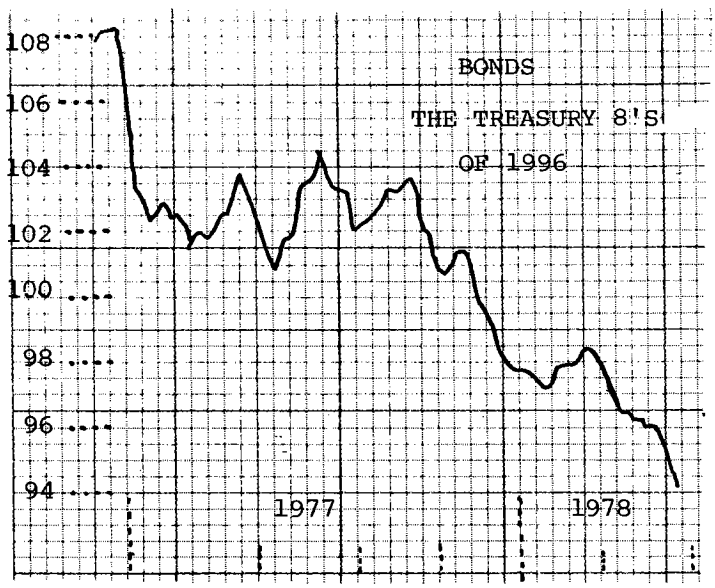
Unfortunately, the US government and its citizens haven't learned what the Cacti have learned. The Cacti have been surviving the cycles for over a million years and the US Government has only been running deficits for 50 years. So it may be that the Government needs a bit more experience. But just as we humans don't decide the timing of the weather, neither do we decide the timing on economic cycles, and trouble (at least economic trouble) has a nasty habit of arriving when we're least prepared for it.

What are we prepared for today? Well, everybody and his brother owes money so the obvious conclusion is that everyone is prepared for inflation (borrow with cheap dollars, pay off with even cheaper dollars). And everyone's prepared to let the Government bail them out, so we can wonder about that one too. Finally, everyone is prepared for "somewhat higher interest rates with a peak not too far ahead." My own feeling is that the peak is not "just ahead" and the highs on interest rates are going to be higher than what is generally expected.

BONDS: People keep telling me that the US is going to "hyper-inflate in order to keep afloat." I tell them, "It can't be done." And the reason is that unlike Brazil or Argentina, the US has **giant capital markets.** We have bond markets that dwarf our stock markets. We have bond markets that represent a goodly portion of the capital worth of the free world. Inflate (as we are now doing) and the bond markets will sink (as they are now doing). Hyper-inflate and the bond markets will crash.

What happens when the bond markets go down? When bonds go down, bond yields go up. When bond yields go up, bonds start to siphon off money from other areas. For instance, let long-term Treasury bonds drop to yields of 9%, 10%, or 11%, and they'll take money out of every pension fund and institutional portfolio in the country. If the bond market smashes, it will act like a giant siphon, sucking money from every corner of the economy. Stocks will crash, and fear will take over. Every seasoned investor watches the bond market out of the corner of one eye. And nothing disturbs him more than trillions of dollars worth of debt instruments sliding relentlessly down in value.

I show here a chart of the bellwether Treasury bond, the 8 of 1996. From a 1977 price of 108 (actually $1,080), this bond dropped to last week's low of just over 94. This represents almost a 13% drop in value, which was typical. Let me put it this way: if this kind of bond action continues, it will bring on a collapse in all markets, because it will represent a loss of billions in the portfolios of investors and institutions and it will destroy confidence in all investments.



The long-term bond market is now telling us that the nation's capital markets are in deep trouble. It's telling us that something has got to change, and fairly fast. What's going to change? My guess is the explosion in loans, and that means business itself. The pressure on the money markets has got to ease, and the only way I know to accomplish this is through recession of one kind or another.

When the pressure lets up, when the bond markets smell recession, the bonds should be "a buy." At that time large commitments in bonds should represent the best and safest kind of speculation-investment. The T-Bonds would represent an investment because they pay a sure 8.5% or more in yield. Since they can also be margined to the hilt, adventurous men and women can turn them into a speculation as well. But right now the bonds are at new lows for the move. We'll talk about them as time goes on, but the time to buy them is–not yet.

GOLD: The forces of inflation (generated by deficits and monetization of the debt) are now clashing head-on with the forces of deflation (brought on by excess loans and almost unmanageable repayment demands). The statistics are bordering on the incredible. Listen to these items from the excellent *Young's World Money Forecast*, 225 Franklin St., Boston, Mass. 02110.

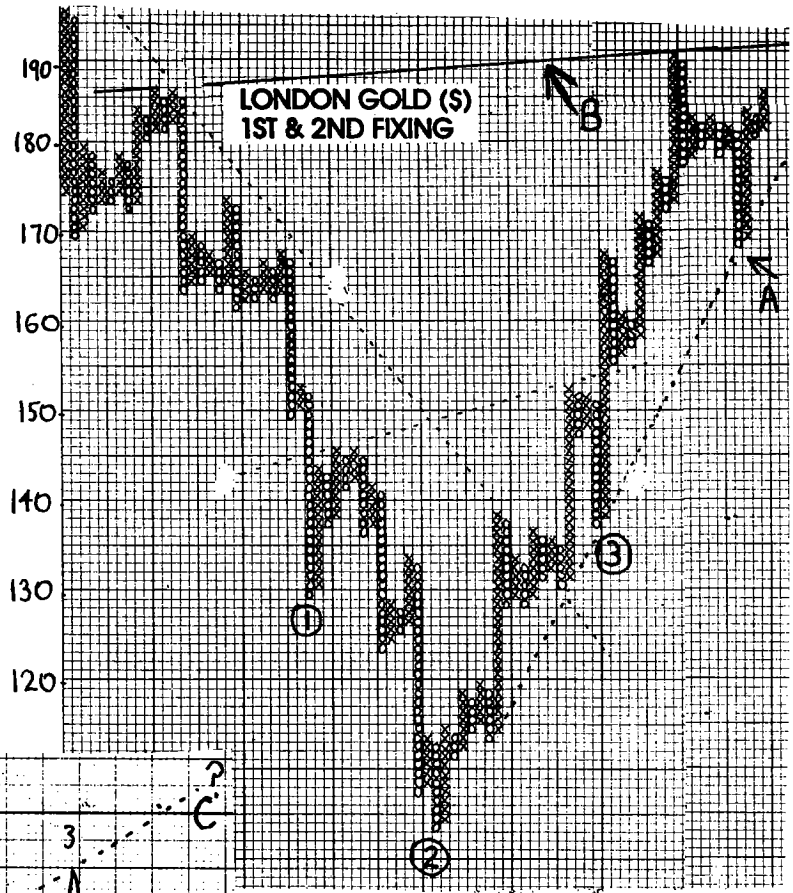
"Data available through May 17 indicates the possibility that May may well prove to be the strongest month for loan demand since July, 1974." "Federal debt grew by a staggering 46% from the fourth quarter of 1974 to the fourth quarter of 1977." "The broad build-up in Federal debt has been necessitated by cumulative budget deficits from 1970-77 totaling $242 billion. By year end 1979, the cumulative total will exceed $330 billion. On a first quarter to first quarter basis, 1978 first quarter Fed. Gov. expenditures were up by 11.7%." "The performance in the US trade account in the first four months of 1978 was dismal. A $12.5 billion deficit has been recorded vs. a deficit of $7.5 billion last year. . . Non-oil imports were up by 37% during the same period."

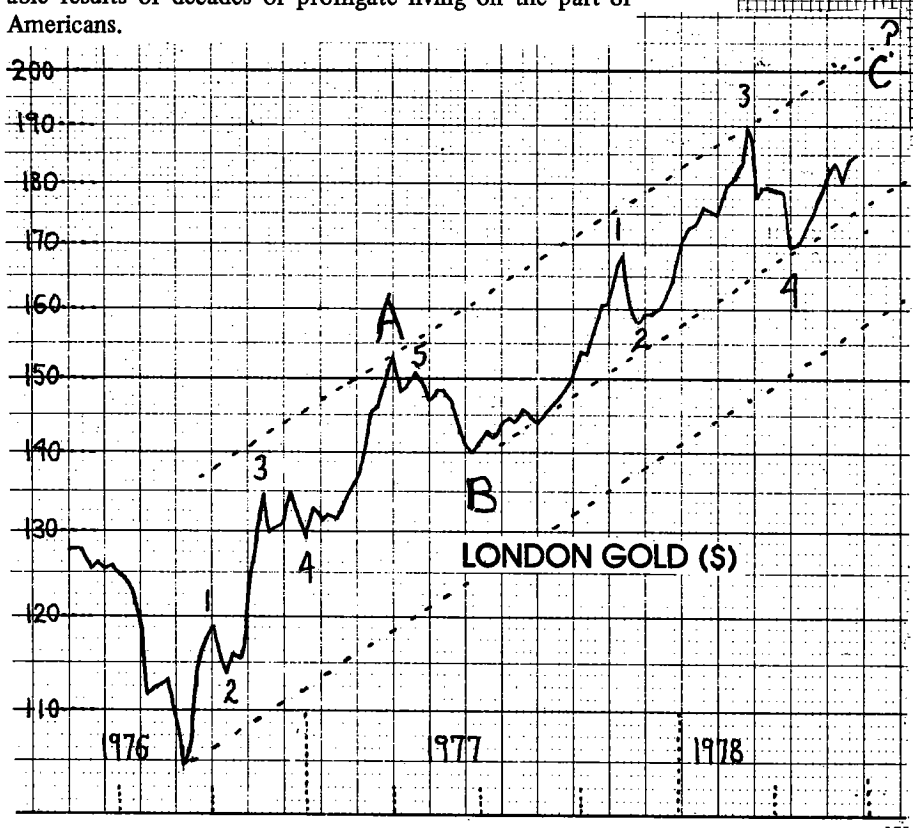
And yet in the face of this veritable ocean of deficit financing, no one is talking about great prosperity, business is not generating

record real profits, and the average American is wondering how to make ends meet. My own feeling is that the Government and the Fed will be faced with even greater problems by yearend 1978, and they will then opt for "more of the same," which means more spending, more deficits, more fiscal insanity.

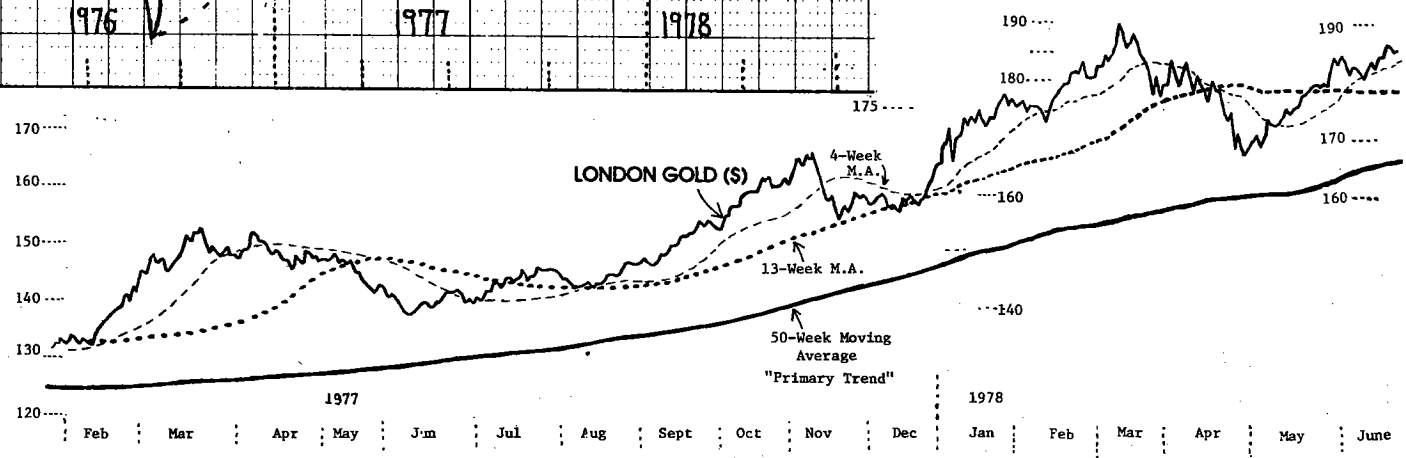
All of this (inflation or deflation notwithstanding) is putting a **floor** under gold. Gold may not be the perfect "insurance poli cy"at this time, but it is a most intelligent one. If the Government is successful in keeping the good times going, then it's going to take bigger and better spending and deficits to do it. In that case, gold should rise. If the US economy topples of its own weight, then the resultant panic will send men scurrying for gold. Either way, gold would seem to be the preferred "survival investment," and that's why I've been recommending it for lo these many months.

"But what about gold as an inflation hedge?" you ask. Frankly, I am more and more agreeing with Harry Browne that inflation is already factored into the price of gold. From here on, I believe gold's greatest value is as a "chaos hedge," a hedge against the as-yet-unforeseen and unknowable results of decades of profligate living on the part of Americans.





How is gold doing? According to my charts, well enough. Perhaps the simplest technical view is provided by my point & figure chart which shows gold on a 1X3 basis (each box is 1 point and reversals of 3 points or more are charted). What we see here is a massive head-and-shoulders **base pattern**, a pattern that implies months and months of accumulation. The "tail" marked A on the chart is what I call a "wipe-out," and such sudden downside reactions take out the weak holders and keep the bullish pattern strong. As I've said for months, gold is currently working on the right shoulder of a huge head-and-shoulders formation. The ultimate breakout target is the resistance line (marked B). Gold recently broke out above the 185 resistance level. A push above line B would entail a move above 190. Such a move, I believe, will arrive in due time.



From another standpoint, my semi-log chart of gold shows the powerful upward thrust which has developed in the metal. Since August 1976 gold has been rising along a wide channel which is depicted by the upper and lower trendlines. A second higher trendline began at point B on the chart.

I have filled in my own Elliott count for gold. The bull market in gold should run in 5 waves in an A-B-C-D-E pattern with waves A, C and E being rising bull waves and B and D being corrective waves.

We have already completed rising wave A, a wave which divided into 5 smaller legs. The correction to point B is now completed. Currently we have completed 1, 2, 3 and 4 of major rising wave C, and we are on wave 5 of larger wave C. The 5-leg is usually the most violent and most speculative, and I find it most interesting that current leg 5 is the one that will grow out of a breakout from the huge base (as shown on the P & F chart).

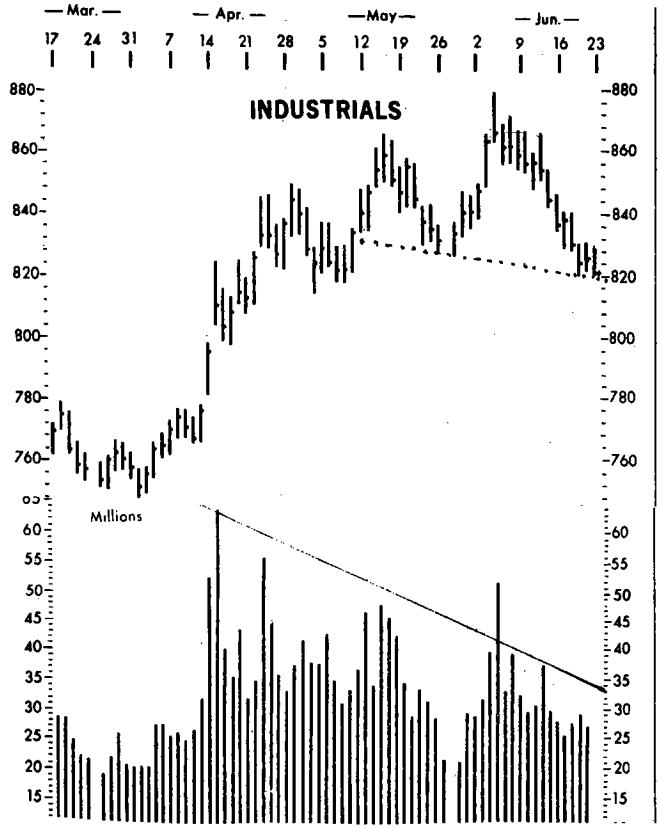
I have not written this before, nor have I seen it said anywhere else. But gold is now poised to push out of its head-and-shoulder base and complete leg 5 or major upward wave C. If all this comes to pass, gold could mount an upward move that could be as spectacular as it would be frightening. On this basis, gold (quiet as it appears now) could be like the oncoming train. Either get on it or get out of its way.

From still another viewpoint (and I am "doing a number" on gold in this mailing because I think the situation is rather dramatic now), the moving averages of gold are telling us something. I show gold since 1977 together with three moving averages. The heavy line is the primary trend line or 50-week MA. This line has now moved up to 166.15, at which point massive support should be forthcoming. The intermediate MA for gold (13-week MA) now stands at 178, and this area should also bring in important support in case of a decline. Finally, the 4-week MA stands at 184. At present, gold acts exceedingly well in that it is above all three MA's. So I.ve told my story regarding gold. From here on, let it tell its own story.

Note: In the last Letter I showed my chart of gold and the gold stock average. As of now, neither has broken out upside, although bullion is trending higher. It would take a combined price of 55 on ASA and Campbell Red Lake to provide a bull signal for gold shares (simply add ASA and CRK together and hope for 55).

LATE NOTES: This report contains an extra two pages, because I had more to say than usual. I never know quite how long to make these Letters. I've had some subscribers write in and say that "it's too much to read, and therefore 8 pages are worse than 6." Others have said that "The more pages the better, keep turning it out." At any rate, I'll probably vary the length of these Letters when the situation demands it, and that's why this Letter is a long one.

During the 5 trading days of June 15 through 21, declines on the NYSE numbered **over 1000 on each session.** Even the 1973-74



crash didn't produce this kind of downside compression on 5 consecutive days! The selling resulted in the A-D ratio breaking below its May low, and this action presents a technical problem for the market. If the market rallies from here, the chances are that the A-D (after its recent swoon) will not confirm any new Dow peaks, and that would mean trouble. On the other hand, if the Dow confirms on the downside by breaking its own May low of 822.07 (May 9) we will then have weakness in both breadth and price, plus the chance of further substantial declines.

At the recent June peak my A-D of the 30 Dow stocks did not confirm. This is most unusual, and it means that fewer and fewer Dow stocks were joining the rally. Thus I am particularly interested in the Dow action from here (Transports are already in a bearish trend). This chart from the Wall Street Journal shows the Dow forming a potential head-and-shoulders top. I have drawn a dotted resistance line. Any Dow rally from here that peters out below the 860 level would serve to form a right shoulder on the pattern. Then a new decline which breaks below the 820's would spell *finis* for the Dow and also project substantially lower prices for the Dow and the market in general. In the meantime, the weakness is covered up by almost absurd speculation in America's newest national industry, gambling. While such backbone-of-the-economy stocks such as GM, US Steel and Union Carbide sell at a fraction of their old bull market highs, the gambling issues explode. Is the market presenting us with a commentary on America's future? I wonder.

SCHULTZ, MARKS? Doctor Smock is a real wise-guy, and as you can see, he's giving his nurse the usual hard time. "But who is the Schultz who was operated on?" I wondered. "Could Godfather Harry Schultz have swallowed little Ryan's diaper pin?

NEXT MAILING: July 12th